3. Domestic economy

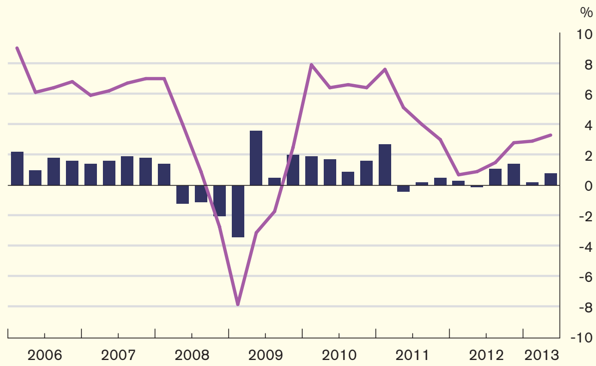
The Hong Kong economy grew slowly in the first half due to drags from trade in goods and moderating domestic demand. For the remainder of 2013, the sequential growth momentum is expected to remain moderate, possibly with stronger external demand being offset by softer private consumption amid increased asset market uncertainty. Inflationary pressure has alleviated slightly since May and is likely to remain steady in the rest of the year.

The labour market held up, with the unemployment rate hovering at a low level. The slightly negative output gap appears to have little impact on the labour demand.

3.1 Aggregate demand

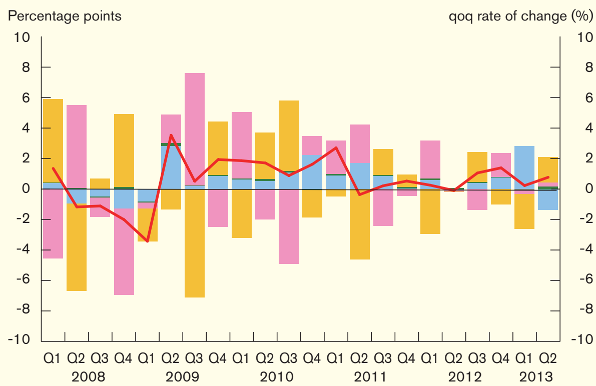
The Hong Kong economy continued to grow at a relatively slow pace during the first half of 2013. On a seasonally adjusted quarter-on-quarter basis, real GDP increased by 0.2% in the first quarter and 0.8% in the second quarter (Chart 3.1). While domestic demand remained the major contributor to growth for the first half as a whole, signs of moderation in private consumption emerged in the second quarter owing in part to increased macroeconomic uncertainty and more volatile financial market conditions (Chart 3.2). Exports of goods continued to be a drag on growth amid feeble demand in the advanced economies and weaker intra-regional trade, while exports of services, particularly inbound tourism, still provided some support. Taken together, net exports remained a drag on real GDP growth for the first half as a whole. Along with the moderate sequential momentum, the year-on-year real GDP growth stalled at 2.9% in the first quarter and rose a little to 3.3% in the second quarter, still some way off the annual average growth of 4.6% over the past 10 years.

Chart 3.1
Real GDP growth



Source: Census and Statistics Department (C&SD).

Chart 3.2
Contributions to quarter-to-quarter percentage change in real GDP



Sources: C&SD and HKMA staff estimates.

This below-trend growth path is expected to continue into the rest of the year. As the recovery in the US economy progresses steadily and the euro area has returned to slow growth by the second quarter, external demand is likely to improve somewhat going forward. However, slower real income growth and less favourable wealth effect from weaker asset markets may translate into softer growth in domestic private consumption, even though the still-positive consumer confidence and resilient employment conditions will continue to render support. While large-scale infrastructure works and private-sector building and construction activities will sustain moderate growth, the momentum of private-sector capital investment is expected to remain weak in the face of concerns over interest rates and liquidity conditions, and cautious business sentiment.

As to GDP forecasts, private-sector analysts have seen less upside to Hong Kong's real GDP and have successively revised downward their growth forecasts to an average of 2.9% for 2013, compared with a high of 3.5% in earlier rounds of forecasts (Chart 3.3). Meanwhile, the Government has narrowed the growth forecast to 2.5 - 3.5% in August, more in line with the range suggested by private-sector forecasters. The softening of the HKMA in-house composite index of leading indicators (in terms of the six-month rate of change) also points to moderate economic growth ahead (Table 3.A).

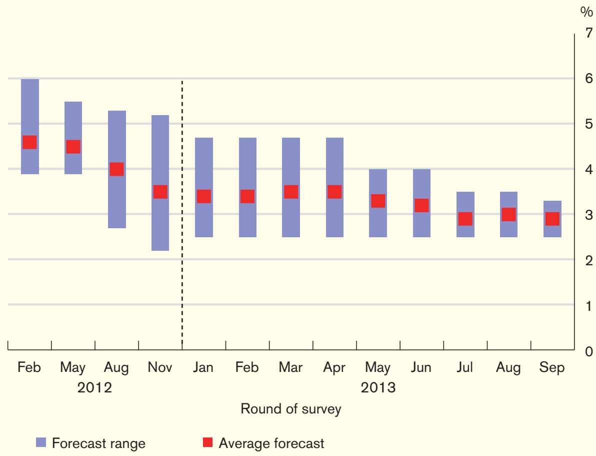
Table 3.A
Recent trends of the coincident economic indicator and the leading economic indicator

	% change over one month		% change over six months	
	CEI	LEI	CEI	LEI
2013				
Jan	1.6	0.9	8.1	3.9
Feb	0.2	0.3	7.1	4.0
Mar	1.3	0.3	7.4	3.9
Apr	1.7	0.4	8.2	3.4
May	-1.1	0.2	5.0	2.9
Jun	0.3	0.0	4.1	2.1
Jul	n.a.	0.5	n.a.	1.7

Note: The six-month rate of change of a leading economic indicator is commonly referred to for detection of any business cycles turning points.

Source: HKMA staff estimates.

Chart 3.3
Consensus forecasts for 2013 real GDP growth



Source: Consensus Economics.

This growth outlook is subject to a number of uncertainties and risks. On the downside, uncertainties surrounding the US monetary stance remain acute and the Mainland China economy still faces latent macro-financial risks. All these could aggravate volatilities in the financial market conditions, fund flows and liquidity situations and overshadow Hong Kong's growth prospects. On the domestic front, risks in the property market still linger, threatening broader macroeconomic adjustments and asset price corrections when external shocks such as interest rate hikes occur. Box 2 further discusses how interest rate hikes in the US could potentially affect the Hong Kong economy by looking at the experience during the 1994 US bond market crash. On the upside, better-than-expected economic performance of the advanced economies and the Mainland China economy could lift global growth and international trade flows, thereby raising Hong Kong's external demand and boosting consumption expenditure perhaps through improved consumer sentiment.

Box 2
Experience of the 1994/95 interest rate up-cycle and its impact on Hong Kong

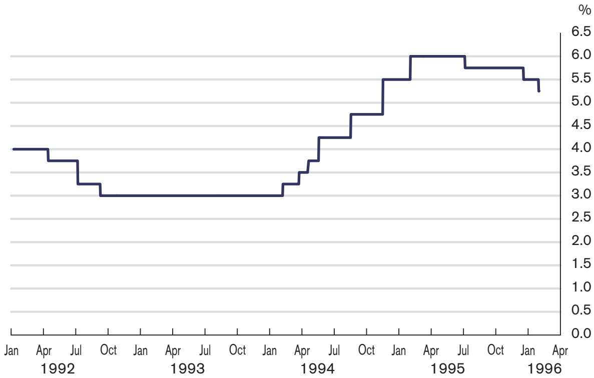
Interest rates have been at extremely low levels in the US since late 2008 as the US Federal Reserve (Fed) lowered the Federal Funds Target Rate to 0 - 0.25% and implemented a series of quantitative easing measures. Now after almost five years, with signs of the US economy on a firmer footing, there is much talk about how the Fed would exit from the easy-money policy. Considerable policy uncertainties remain that could easily upset the financial markets and have important ramifications on the macro-economy.

In the Fed's history, there was an episode of policy tightening that might provide a guide to what could happen as the Fed exits its quantitative easing policy. In this Box, we review the experience of policy normalisation by the Fed during 1994-95 and its economic and financial impact on Hong Kong.

Experience of the 1994/95 interest rate up-cycle

In February 1994, the Fed started to tighten its monetary policy stance after keeping the policy rate unchanged at a multi-decade low of 3% for more than five quarters (Chart B2.1). In the following 12 months, it raised the policy rate by a total of 300 basis points to 6%. This rate hike cycle was largely triggered by the Fed's concerns about re-acceleration of inflation at that time. The economy had been out of the recession of the early 1990s for almost two years (during which the Fed had maintained a monetary stance more accommodative than that implied by the Taylor rule to stimulate growth as well as to support a banking sector which was hit by the savings and loan crisis) and growth momentum was accelerating, narrowing the negative output gap. Although inflation had not yet picked up notably, the Fed decided to hike policy interest rate so as to pre-empt inflation rate and normalise the overly-accommodative monetary stance.

Chart B2.1
US Federal Funds Target Rate in 1992-96



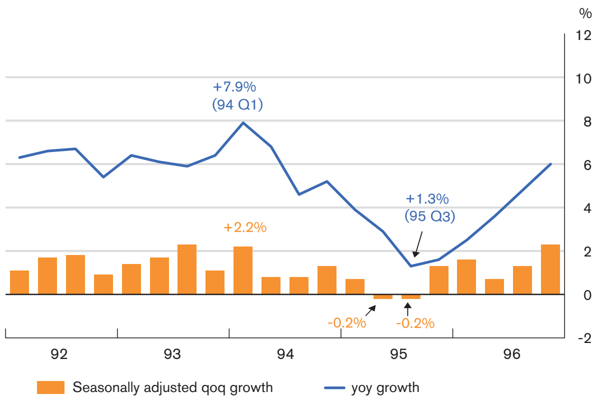
Source: Board of Governors of the Federal Reserve System.

The rapid interest rate hikes shocked the US financial markets, ensuing sell-offs in the Treasury market. The benchmark constant maturity 10-year Treasury yield shot up from 5.8% just before the first rate hike in early February 1994 to a peak of about 8% in November. Short-term Treasury yields rose even more, flattening the yield curve. The low and stable interest rate environment and steep yield curve before the February 1994 rate hike fostered the perception of one-way bet. As a result, financial institutions took up sizable leveraged position in the bond market by going long longer-term fixed income securities funded by short-term borrowing, i.e. carry trade. The budding derivatives market added fuel to the fire.

As the Fed tightened, the market suddenly realised that liquidity had been very concentrated and everyone was in the same trade. In other words, there was a bubble in the bond market. The simultaneous liquidation of leveraged positions following the Fed's rate hike burst the bubble and led to a panic sell-off and crash in the US bond market. This was accompanied by wholesale dumping of bonds in Europe and Asia as well. In terms of real activities, there was no severe impact on the US, with real output and unemployment continuing to improve amid stable inflation.

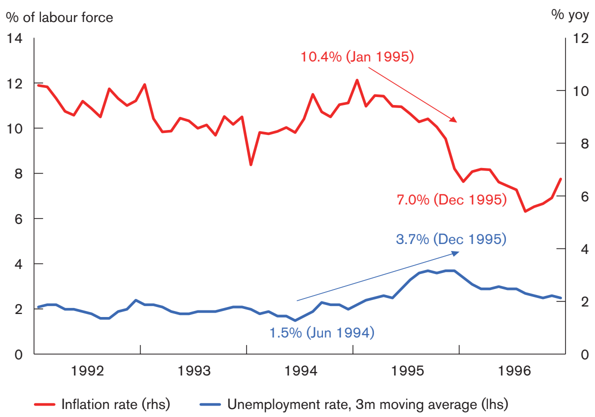
The impact on Hong Kong was mildly negative, without degenerating into a full-blown financial crisis. Hong Kong's real GDP growth moderated below trend for six quarters between the second quarter of 1994 and the third quarter of 1995 (Chart B2.2). Private consumption softened due to worsening employment conditions, fragile sentiment and the negative wealth effect of asset price adjustments, while fixed investment remained supported by large-scale infrastructure works and private-sector capital spending. The unemployment rate climbed from 1.5% in June 1994 to 3.7% in December 1995, while inflationary pressure began to ease from early 1995 (Chart B2.3).

Chart B2.2
Hong Kong's real GDP growth in 1992-96



Source: C&SD.

Chart B2.3
Inflation and unemployment in 1992-96

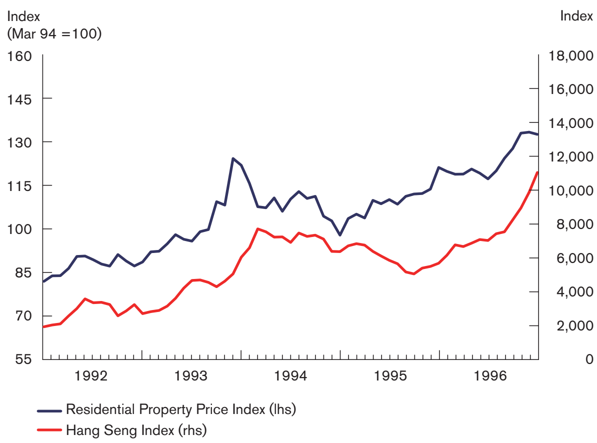


Source: C&SD.

Monetary conditions also tightened noticeably, with the Hong Kong dollar interbank rates rising in close parallel with their US dollar counterparts and loan growth slowing. By January 1995, the three-month HIBOR had risen to around 7.2%. Compared with the 300-basis-point increase in the Fed Funds Target Rate, Hong Kong's Best Lending Rate climbed by 250 basis points to 9.0% and the average mortgage interest rate rose by the same amount to 10.75%. Growth in domestic credit moderated on a broad base from 18.0% in 1994 to 12.0% in 1995.

Meanwhile, the equity market faced significant sell-off pressure, with the Hang Seng Index plunging 43% over a year (Chart B2.4). Though it bounced back in 1995, the Hang Seng Index remained 17% off the high before the market sell-off. Based on our crude estimates, there were net outflows of about HK$24 billion (2% of GDP) from Hong Kong, although this only occurred briefly in February - May 1994 and was quickly offset by inflows later in the year.[17] Housing prices saw a protracted decline and fell 16% over 19 months, while transaction volume fell by about one-third. But on the whole, the tighter credit conditions and asset price corrections did not severely weigh on Hong Kong's macroeconomic and financial stability.

Chart B2.4
Equity prices and housing prices in 1992-96



Sources: R&VD and CEIC.

[17] The estimates are based on the combined changes in AI's net spot foreign currency positions, the banking sector's balances and Exchange Fund papers. Roughly speaking, the estimates refer to net Hong Kong dollar fund flows into and out of the non-bank private sector.

Conclusions

The lesson from the 1994/95 episode of policy normalisation is that market reactions triggered by policy surprises can be very large, particularly if imbalances had already built up during a prolonged extreme policy environment. While the impact of the 1994/95 episode on Hong Kong was relatively mild, this was in large part due to stronger external demand partially offsetting the negative impact from repricing of the yield curve. Fast forward to the present, the potential impact on Hong Kong from Fed's policy normalisation could be larger, given that some domestic imbalances have been building up, particularly in the property market. Therefore, readers should be vigilant and brace themselves for the potential volatilities and shocks from the Fed's policy normalisation.

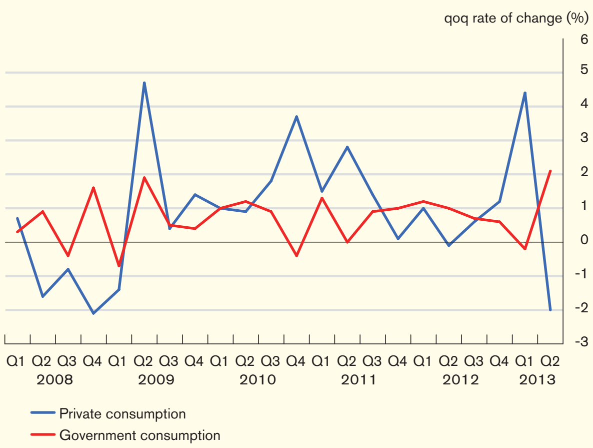
3.2 Domestic demand

Consumption

Private consumption remained relatively strong in the first half on the back of broadly supportive labour market conditions. The sequential path was however volatile, with an outsized growth of 4.4% in the first quarter followed by a 2.0% decrease in the second quarter. The ease-back appeared to be largely a technical decline due to the high base effect, though it also partly reflected somewhat softer consumption demand dragged by weaker local stock market performance and increased macro-financial uncertainties (Chart 3.4). However, given that consumer confidence is still broadly positive and the employment conditions remain resilient, it is expected that private consumption will sustain moderate growth in the remainder of the year. Overall, the latest market consensus expects a 4.5% growth for 2013, compared with 3.0% in 2012.

By contrast, government consumption contracted a little by 0.2% in the first quarter and rebounded strongly by 2.1% in the second quarter (Chart 3.4). Its growth rate is expected to remain robust in the rest of the year. According to the 2013/14 Budget, the recurrent part of public expenditure is projected to rise by 8.4% in real terms in the current fiscal year, higher than the 6.8% increase in 2012/13.

Chart 3.4
Private and government consumption



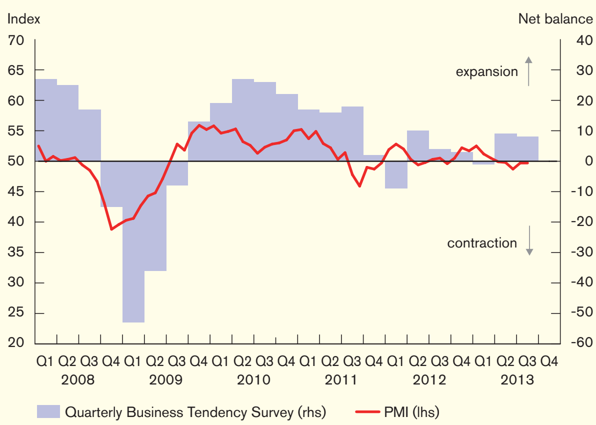
Source: C&SD.

Investment

Overall investment spending went through a soft patch, with a mild dip in the first quarter roughly compensated by a pick-up in the second quarter. In particular, gross fixed capital formation improved sequentially in the second quarter amid stronger private-sector building and construction activities and a revival in business capital spending (partly driven by increased purchases of aircraft). Public-sector infrastructure works continued to moderate after several years of strong growth. Inventory investment was relatively stable.

Looking ahead, building and construction activities are expected to progress steadily in the remainder of the year as private-sector building approvals have broadly trended up. The on-going large-scale public infrastructure works should also render support, but only modestly due to the high base effect. As for private-sector capital investment, the near-term outlook continues to be less certain amid headwinds from the volatile stock markets and increased concerns over interest rates and liquidity conditions. Business sentiment also remains cautious, with a mixed bag of data from the Quarterly Business Tendency Survey (QBTS) and the PMI readings (Chart 3.5). The latest market consensus expects growth in gross fixed capital formation to moderate to 4.8% in 2013 from 9.4% last year.

Chart 3.5
Business sentiment

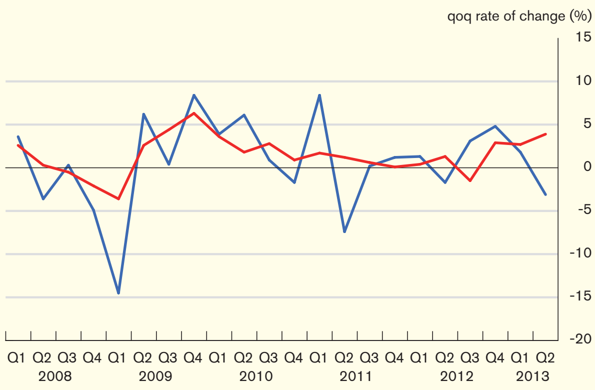


Sources: C&SD and Markit Economics.

3.3 External trade

Hong Kong's export performance was sluggish in the first half due to weak demand from the advanced economies and moderating intra-regional trade. Exports of goods fell by 3.1% in the second quarter after increasing by a modest 1.8% in the previous quarter (Chart 3.6). The markets of the US, European Union and Japan were weak throughout the first half and exports to Mainland China slowed visibly in the second quarter. In contrast, exports of services grew faster at 3.9% in the second quarter compared with 2.7% in the first quarter. While inbound tourism continued to render support, contributions from merchanting and financial services were subdued amid lacklustre merchandise trade flows.

Chart 3.6
Exports of goods and services



Source: C&SD.

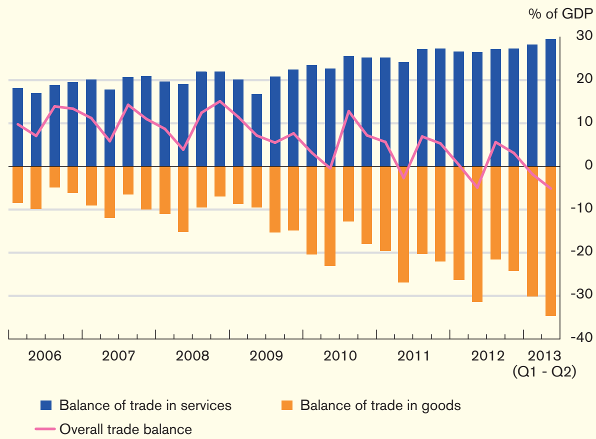
Imports of goods grew by 3.1% in the first quarter but weakened to post a 2.2% decline in the second quarter (Chart 3.7). This was mainly due to renewed drags from export-induced import demand (as reflected in re-exports of goods). Retained imports, on the other hand, picked up in the second quarter after a moderate decrease in the first quarter. Meanwhile, weaker outbound tourism and demand for professional and financial services caused imports of services to fall by 3.0% in the second quarter, offsetting the 1.9% increase in the first quarter.

Chart 3.7
Imports of goods and services

Sources: C&SD and HKMA staff estimates.

Net exports added 1.7 percentage points to real GDP growth in the second quarter after two quarters of notable drags. But this improvement was largely due to the weaker performance of imports than that of exports. In value terms, the seasonally unadjusted overall trade balance recorded a deficit of $34.5 billion (3.5% of GDP) in the first half of 2013, compared with a $21.6 billion (2.3% of GDP) deficit in the first half of 2012 (Chart 3.8).

Chart 3.8
Trade balance by component (in nominal terms)



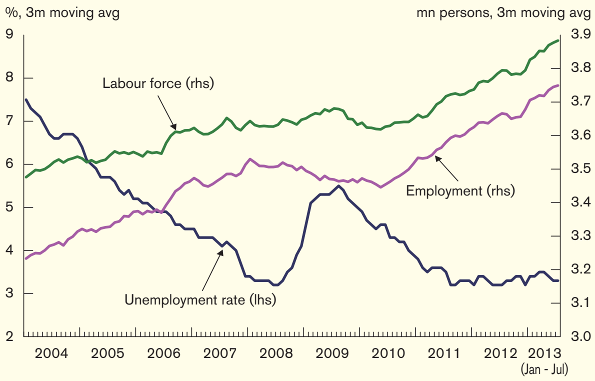
Source: C&SD.

Going forward, despite some slowdown in Mainland China's economy and in the region, overall external demand for Hong Kong's exports is likely to grow modestly on the back of the accelerating pace of recovery in advanced economies (especially the US). The latest QBTS also pointed to a slight improvement in Hong Kong's exports of goods. On the other hand, softening inbound tourism and weak external demand for professional and financial services would weigh on Hong Kong's services exports. With domestic demand starting to moderate, imports of goods and services will likely progress quite steadily.

3.4 Labour market conditions

The labour market held up despite moderating growth momentum in the economy. The seasonally adjusted three-month moving-average unemployment rate returned to 3.3% in July 2013 after edging up to 3.5% in March and April (Chart 3.9). The labour force participation rate remained on the uptrend, increasing to 61.6% in July 2013, the highest level since 2007. Meanwhile, the employment figure also reached a record high of 3.75 million in the same month. Tightness in the labour market was broad-based, with the unemployment rate in major sectors, such as financing, insurance, real estate, professional and business services and transportation, storage, postal, courier services, information and communications, staying low in the period.

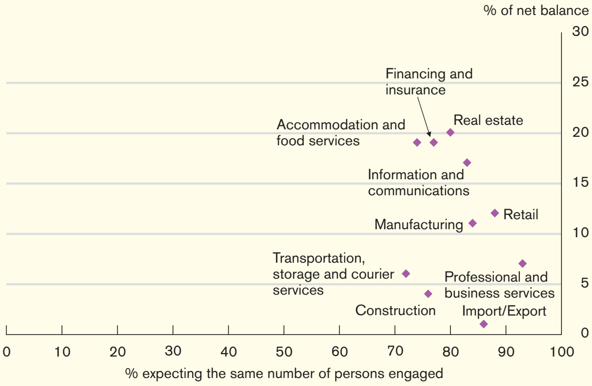
Chart 3.9
Labour market conditions



Source: C&SD.

In the near term, the labour market will continue to be supported by the resilient domestic demand. In the latest QBTS for the third quarter 2013, respondents from all surveyed sectors anticipate a rise in their employment in the near term, indicating the robust demand for labour (Chart 3.10).

Chart 3.10
Quarterly Business Tendency Survey for third quarter: employment



Notes:

1. Net balance refers to the difference between the percentage points of respondents expecting a rise over those expecting a decline.
2. Sectors are classified according to the new Hong Kong Standard Industrial Classification Version 2.0 (HSIC V2.0).

Source: C&SD.

While the potential output continued to edge up in the first half amid the expansion of labour force and its participation rate, the actual economic growth was at a relatively moderate pace, driving the economy to operate at a level slightly below its potential. Nonetheless, the narrow negative output gap appears to have little impact on the labour market, with the unemployment rate staying relatively low.

Labour costs edged up slightly in the first quarter of 2013 when compared with the previous quarter. While the real payroll per person drifted down by 0.2% in the first quarter (Chart 3.11), the faltering momentum of output growth has weighed more on labour productivity, driving up the real unit labour costs up by 0.8% in the period.

Chart 3.11
Unit labour cost and labour productivity

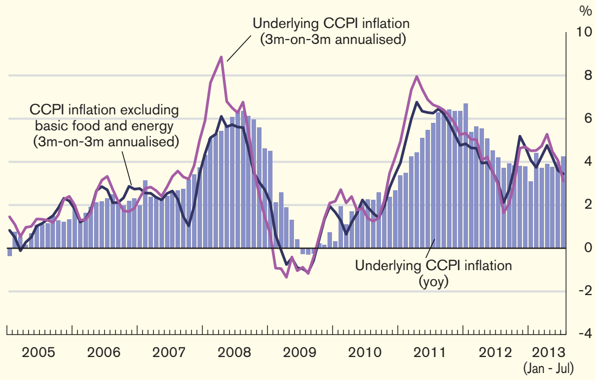
Sources: C&SD and HKMA staff estimates.

Looking ahead, the overall labour market is expected to remain tight, as the resilient domestic sector continues to support job creation. Nonetheless, hiring sentiment may become cautious, reflecting concerns over the Fed tapering its asset purchase programme and the Mainland China's slowdown.

3.5 Consumer prices

Local inflationary pressure stayed firm during the first four months of 2013 but has slightly moderated since May. After reaching 5.3% in April, the annualised three-month-on-three-month underlying inflation rate slowed to 3.1% in July (Chart 3.12). Excluding the volatile components of basic food and energy, the core underlying inflation rate shared a similar trend, indicating that the upward price pressures may have moderated. Despite the swings in the sequential momentum, the year-on-year underlying inflation rate remained relatively stable at about 3.9% during the first seven months of 2013 except for the fluctuation in January and February due to differences in the timing of the Chinese New Year.

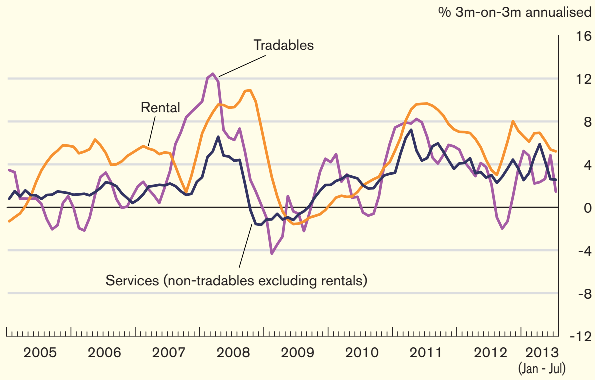
Chart 3.12
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

The recent alleviation in the sequential inflation momentum was largely driven by the non-tradables and rentals (Chart 3.13). In particular, the non-tradable component inflation rose to 5.9% in April before coming down to 2.6% in July, mainly attributable to a similar trend in the miscellaneous service component. The rental component inflation also slowed to 5.2% in July from 6.9% in April. On the other hand, driven by the basic food component, the tradable component inflation edged up between April and June before retreating in July.

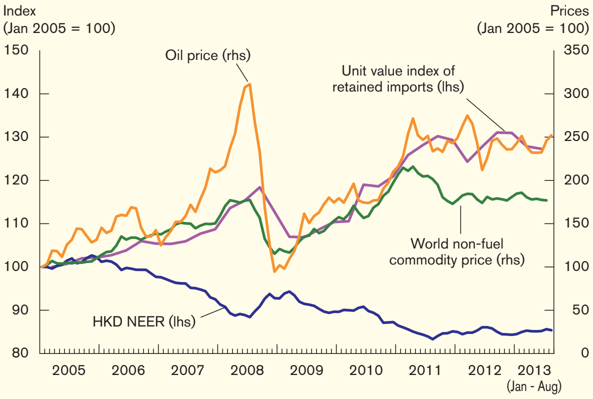
Chart 3.13
Consumer price inflation by broad component



Sources: C&SD and HKMA staff estimates.

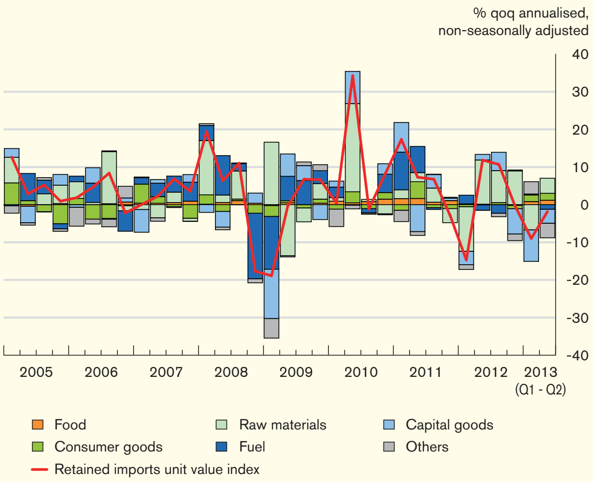
Import price inflationary pressures eased in the first half of 2013 amidst softened global commodity prices. The quarter-on-quarter annualised inflation rate decreased to -9.0% in the first quarter and only moderated to -1.8% in the second quarter (Chart 3.14). Analysed by end-use category, capital goods component has become the main driver of import price decline (Chart 3.15).

Chart 3.14
Commodity and import prices



Sources: C&SD and IMF.

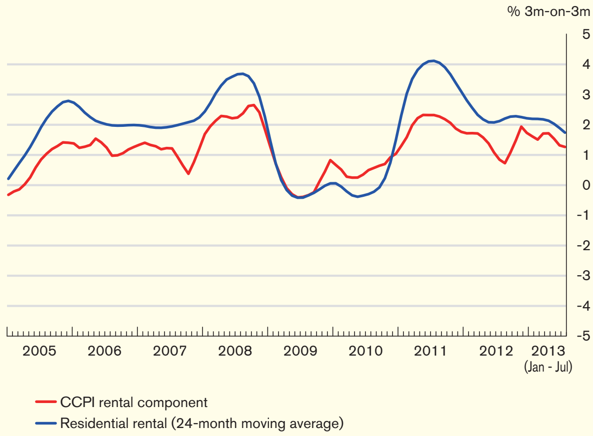
Chart 3.15
Contributions to import price inflation



Sources: C&SD and HKMA staff estimates.

Looking ahead, the sequential inflation momentum is likely to ease slightly amid the alleviated housing rentals (Chart 3.16). The annual year-on-year inflation rates in 2013 may remain steady, with the latest Government forecast for the underlying inflation rate revised downward slightly from 4.2% to 4.0%. Moreover, the local output gap is estimated to be slightly negative in the first half of 2013, restraining the near-term labour cost pressures.

Chart 3.16
CCPI rental component and market rentals



Note: CCPI rental component excludes the effects of one-off special relief measures.
Sources: Rating and Valuation Department (R&VD), C&SD and HKMA staff estimates.

The inflation outlook is subject to risks on both sides. On the upside, the geopolitical tension in Middle East may boost the oil price. On the downside, the US tapering its asset purchase programme and Mainland China's slowdown may pose negative risks to global economic activity and, consequently, local inflationary pressure.